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September 15, 2008

By Courier

Vernon A. Williams
Secretary
Surface Transportation Board
395 E Street, S.W.
Washington, D.C. 20005

223602

Re: STB Ex Parte No. 664 (Sub-No. 1), *Use of a Multi-Stage Discounted Cash Flow Model In Determining the Railroad Industry's Cost of Capital*

Dear Secretary Williams:

Pursuant to the Notice served August 11, 2008, in the above-referenced proceeding, please find enclosed for filing the original and ten (10) copies of the Comments of the Association of American Railroads ("AAR").

If you have any questions, please contact the undersigned counsel.

Sincerely,

Richard E. Young

*Counsel for the Association of
American Railroads*

Enclosures

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

223602

USE OF A MULTI-STAGE DISCOUNTED
CASH FLOW MODEL IN DETERMINING
THE RAILROAD INDUSTRY'S
COST OF CAPITAL

Ex Parte No. 664
(Sub-No. 1)

**COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS**

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**BEFORE THE
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**COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS**

Pursuant to the schedule established by the Board's Notice served August 11, 2008 ("Notice"), the Association of American Railroads ("AAR") and its members respectfully submit these Comments in the above-captioned proceeding.

INTRODUCTION AND SUMMARY

The Board should adopt its proposal that it "determine the cost of equity of the railroad industry by using the average of the estimate produced by the CAPM model and the Morningstar/Ibbotson multi-stage DCF model identified by [the] AAR." Notice at 4. *See also id.* at 6. The AAR fully agrees with the Board that using the average of the two models will "produce[] a more stable and more precise cost of equity estimate." *Id.* at 5.

The Board's selection of the Morningstar/Ibbotson model as the appropriate multi-stage DCF to be used is eminently correct. As the Notice states, that model "is a commercially accepted multi-stage DCF model" that "is used to estimate the cost of equity for different industries, not just the rail industry." *Id.* at 5-6. Equally important, as the AAR has previously

demonstrated, the Morningstar/Ibbotson model meets all four of the criteria that the Notice described for a proper multi-stage DCF.¹ Specifically:

- The Morningstar/Ibbotson model is a true multi-stage DCF. The model uses more than one stage, and more than one growth rate.
- The Morningstar/Ibbotson model does not focus exclusively on dividends. Instead, the model uses a broader measure of cash flow.
- The Morningstar/Ibbotson model can be modified to include only those railroads that pass the screening criteria set forth in *Railroad Cost of Capital – 1984*, 1 I.C.C.2d 989 (1985) – *i.e.*, Burlington Northern Santa Fe (“BNSF”), CSX Transportation, Inc. (“CSXT”), Norfolk Southern (“NS”), and Union Pacific (“UP”).
- The Morningstar/Ibbotson model, when used in combination with the CAPM, would enhance the precision of the Board’s calculation of the cost of equity. When averaged together, the two models produce more precise and less volatile estimates (*i.e.*, lower standard deviations) over time than either model alone.

Contrary to the position previously expressed by the Western Coal Traffic League (“WCTL”), the Board should promptly adopt the proposed methodology and begin using the Morningstar/Ibbotson model for future calculations of the cost of equity. The alleged problems that WCTL cites as justifications for postponing the use of a multi-stage DCF simply do not exist in the Morningstar/Ibbotson model.

ARGUMENT

I. THE BOARD SHOULD ADOPT ITS PROPOSAL TO USE THE MORNINGSTAR/IBBOTSON MULTI-STAGE DCF MODEL.

As the Notice correctly posits, the Morningstar/Ibbotson model is both sound and reliable. Morningstar routinely uses the three-stage DCF model to determine, and publish, estimates of the cost of equity for a wide range of industries, including the railroad industry. *See*

¹ *See* Notice at 3-4; Comments of the Association of American Railroads filed April 14, 2008, in Ex Parte No. 664 (Sub-No. 1) (“April 14 AAR Comments”), at 6-12 & Verified Statement of Bruce E. Stangle (“Stangle V.S.”).

Notice at 5-6; Stangle V.S. ¶¶ 3, 7, 18. This three-stage DCF is an objective, unbiased tool for calculating the cost of equity, because it “was developed by disinterested, respected third parties and created for use by the financial community in evaluating publicly traded equities and in making real-world investment decisions. It was not developed as a tool for litigation for advocacy, and the same model is used by Morningstar to estimate the cost of equity for hundreds of different industries.” Notice at 5; *see also* April 14 AAR Comments at 8 & Stangle V.S. ¶¶ 3, 7, 18, 22. Moreover, the model can be estimated from readily available data and can be modified to estimate the cost of equity for a particular group, such as the group of railroads passing the Board’s screening criteria. Notice at 5; Stangle V.S. ¶¶ 3, 7, 11.

The Board is also correct in concluding that the Morningstar/Ibbotson model meets all four of the requirements that a multi-stage DCF must satisfy. *See* Notice at 3-6. First, the proposed Morningstar/Ibbotson model is a true multi-stage model. The model uses three stages: Stage 1, which represents the first 5 years; Stage 2, which represents the 6th through 10th years; and Stage 3, which represents all years following the first 10. *Id.* at 5; *see also* Stangle V.S. ¶¶ 13-15. Moreover, the model uses three different growth rates:

- In each of the first five years (Stage 1), the growth rate used is the median value of the three- to five-year growth estimates for each of the four railroads (BN, CSXT, NS, and UP) as provided by railroad industry analysts.
- During years six through ten, the growth rate is the average of the earnings growth for the four railroads, taken as a whole.
- Beginning in year 11 and thereafter, the growth rate is assumed to be the long-run nominal growth rate of the aggregate U.S. economy.

Notice at 5; Stangle V.S. ¶¶ 13-16. Thus, the Morningstar/Ibbotson model eliminates the possibility that the cost of equity might be overstated due to a constant growth rate. *See* Stangle V.S. ¶ 15.

Second, the Morningstar/Ibbotson model is not based on dividend payments alone. *See* Notice at 5. The model “incorporates a wider array of cash flows for equity investors by applying expectations of earnings growth to the firms’ cash flows, not just actual dividends.” *Id.*; *see also* Stangle V.S. ¶¶ 6, 11-12. In short, the Morningstar/Ibbotson approach captures all of the relevant cash flows that investors are likely to anticipate, whether those cash flows take the form of dividends, share repurchases, or reinvestment of earnings to obtain greater cash flows in the future. *Id.*

Third, the Morningstar/Ibbotson model can readily be modified so that it includes only the railroads that pass the screening criteria set forth in the *Railroad Cost of Capital – 1984* decision -- *i.e.*, BNSF, CSXT, NS, and UP. Notice at 5. Each of those four railroads is a Class I carrier that: (1) has rail assets greater than 50 percent of its total assets; (2) has a debt rating of at least BBB (Standard & Poor’s) and Baa (Moody’s); (3) is listed on the New York Stock Exchange; and (4) pays dividends throughout the years. *See id.* at 4-5; Stangle V.S. ¶ 10.

Fourth, “When combined with CAPM and applied over a sufficiently lengthy historical analysis period, the Morningstar/Ibbotson multi-stage DCF model enhances the precision of the resulting cost-of-equity estimate with a lower variance than a forecast relying on the CAPM approach alone.” Notice at 5; *see also* Stangle V.S. ¶¶ 19-22. For the four Class I railroads that pass the Board’s screening criteria, the multi-stage Morningstar/Ibbotson model produces a cost of equity ranging from 11.6 percent to 14.6 percent for the period from 1998 through 2007. Stangle V.S. ¶ 19. Over the same period, the CAPM methodology yields estimates ranging from 9.7 percent to 12.7 percent. *Id.* Averaging the estimates from the two models results in an estimate in the range of 11.1 percent to 13.4 percent. *Id.* ¶ 20.

The standard deviation of these estimates (which is a standard statistical measure of dispersion) confirms that averaging the results of the Board-approved CAPM and the proposed

multi-stage Morningstar/Ibbotson DCF creates a more stable estimate of the railroads' cost of equity. The standard deviation of the average is only 75 basis points (0.75 percentage points), which is considerably lower than the standard deviation of the CAPM estimates and DCF model estimates taken separately. Notice at 5; Stangle V.S. ¶ 21. *Id.* Thus, the combination of the two models "produces a more stable and more precise cost-of-equity estimate" than either model alone. Notice at 5; *See also* Stangle V.S. ¶¶ 6, 21-22.

Given these results, the answer to the additional question posed in the Notice is clear. *See* Notice at 6 (requesting parties to comment "on the best way to integrate the two approaches and whether a simple average is the best approach"). Because the record shows that averaging the results of the CAPM and Morningstar/Ibbotson models produces a more stable and reliable estimate of the railroad industry's cost of equity, such averaging is clearly the best approach for calculating the COE.

II. THE BOARD SHOULD REJECT WCTL'S PROPOSAL TO DEFER THE USE OF A MULTI-STAGE DCF.

In the comments which it filed last April in this proceeding, WCTL argued that the Board should not adopt *any* multi-stage DCF model at this time, due to: (1) the "sharp year-to-year fluctuations or lumpiness in the underlying cash flows" for BNSF, CSXT, NS, and UP; and (2) the "additional time and resources" that would be required to prepare a multi-stage DCF in addition to the CAPM. Instead, WCTL suggested that the Board "revisit the matter after a period of time such as five years," after it has had experience working with the CAPM (or if the CAPM results should exhibit instability). *See* WCTL Comments filed April 14, 2008, at 2-3, 10-11.

WCTL's position is without merit. The Board should promptly adopt the Morningstar/Ibbotson model and begin using it in calculating the cost of equity.

As a preliminary matter, the reasons offered by WCTL for deferring adoption of a multi-stage DCF appear to be newly invented. In the comments which it filed in the Ex Parte No. 664 proceeding, WCTL endorsed the use of a multi-stage DCF in conjunction with the CAPM. *See* April 14 AAR Comments at 4-5 & nn.3-4 (describing WCTL's submissions). None of WCTL's comments in that proceeding – which were filed as recently as last December – expressed the reservations that it has now surfaced here concerning the adoption of a multi-stage DCF.

In any event, the Morningstar/Ibbotson model avoids the problems described by WCTL. First, the Morningstar/Ibbotson model is stable. The model, for example, computes total cash flows for a five-year period and then divides the total by total sales to compute a five-year cash-flow-to-sales ratio, which is then multiplied by the more recent year's sales to obtain an average cash flow estimate for that year. *See* Stangle V.S. ¶ 12. This averaging approach eliminates any problem of “fluctuations” or “lumpiness” in cash flows. WCTL itself has acknowledged that averaging will “smooth[] out the annual fluctuations.” WCTL Comments at 2.

Second, using the Morningstar/Ibbotson model along with the CAPM will not require substantial additional time and resources. The Morningstar/Ibbotson model is a commercially accepted model that can be estimated from readily available data, and can readily be modified to include only the four railroads that meet the *1984 Cost of Capital* criteria. *See* Notice at 5; April 14 AAR Comments at 8, 12. The relatively limited additional costs of using the model are more than justified by the increased reliability that the use of the model will achieve in computing the cost of equity. *See* Notice at 2-3 (noting economic literature confirming that “in many cases, combining forecasts from different models is more accurate than relying on a simple model”).

CONCLUSION

For the foregoing reasons, the Board should promptly adopt its proposal to use the Morningstar/Ibbotson multi-stage DCF model for use in cost of capital determinations, and should compute the cost of equity by averaging the results of that model with those of the CAPM.

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September 15, 2008

CERTIFICATE OF SERVICE

I hereby certify this 15th day of September, 2008, that I have served copies of the foregoing on all parties of record in this proceeding.

RMB